

DEACONESS HOSPITAL 150082

**DEACONESS HEALTH SYSTEM, INC.**

**FINANCIAL STATEMENTS**

**AND**

**SUPPLEMENTARY INFORMATION**

**SEPTEMBER 30, 2007 AND 2006**

*CPAs / ADVISORS*



# DEACONESS HEALTH SYSTEM, INC.

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## REPORT OF INDEPENDENT AUDITORS

Board of Directors  
Deaconess Health System, Inc.  
Evansville, Indiana

We have audited the consolidated balance sheets of Deaconess Health System, Inc. (System) as of September 30, 2007 and 2006 and the related consolidated statements of operations and changes in net assets and cash flows for the years then ended. These consolidated financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the System as of September 30, 2007 and 2006 and the consolidated results of its operations, changes in net assets and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The accompanying supplementary information as of and for the year ended September 30, 2007 is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in our audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

*Blue & Co., LLC*

December 5, 2007

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2007 AND 2006

ASSETS		
	2007	2006
<b>Current assets</b>		
Cash and cash equivalents	\$ 20,132,301	\$ 19,917,854
Funds held by trustee, current portion	1,216,664	1,166,556
Patient accounts receivable, less allowance for estimated uncollectible amounts of \$15,119,000 in 2007 and \$10,554,000 in 2006	82,737,622	74,262,615
Inventories	2,292,081	2,679,419
Prepaid expenses and other current assets	6,852,211	6,133,547
Total current assets	113,230,879	104,159,991
<b>Investments limited as to use, less current portion</b>		
Board designated funds	142,497,588	95,237,527
Temporarily restricted	9,206,691	10,434,712
Total investments limited as to use	151,704,279	105,672,239
<b>Property and equipment</b>		
Land and improvements	17,240,539	17,030,276
Buildings and fixed equipment	361,327,371	354,970,111
Movable equipment	160,251,835	153,576,270
	538,819,745	525,576,657
Less allowances for depreciation	270,646,009	239,061,864
	268,173,736	286,514,793
Construction in progress	6,691,971	10,379,092
Total property and equipment, net	274,865,707	296,893,885
<b>Other assets</b>		
Deferred financing costs	2,841,661	3,016,459
Investments in joint ventures and other	31,651,275	34,697,844
Total other assets	34,492,936	37,714,303
Total assets	\$ 574,293,801	\$ 544,440,418

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2007 AND 2006

### LIABILITIES AND NET ASSETS

	2007	2006
<b>Current liabilities</b>		
Accounts payable and other current liabilities	\$ 17,957,838	\$ 14,074,551
Salaries, wages and related liabilities	18,189,714	16,259,341
Estimated third-party payor settlements	909,265	4,997,280
Accrued interest	634,658	665,120
Current portion of long-term debt	4,580,528	4,253,495
Total current liabilities	42,272,003	40,249,787
<b>Long-term liabilities</b>		
Long-term debt, less current portion	150,632,601	155,347,784
Other long-term liabilities	14,349,944	3,340,923
Total long-term liabilities	164,982,545	158,688,707
Total liabilities	207,254,548	198,938,494
<b>Net assets</b>		
Unrestricted	357,832,562	335,067,212
Temporarily restricted	9,206,691	10,434,712
Total net assets	367,039,253	345,501,924
Total liabilities and net assets	<u>\$ 574,293,801</u>	<u>\$ 544,440,418</u>

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND CHANGES IN NET ASSETS YEARS ENDED SEPTEMBER 30, 2007 AND 2006

	2007	2006
<b>Unrestricted revenue and other support</b>		
Net patient service revenue	\$ 452,817,207	\$ 408,636,200
Other revenue	21,670,066	18,156,868
Total unrestricted revenue and other support	474,487,273	426,793,068
<b>Expenses</b>		
Salaries and wages	159,631,654 ✓	155,018,602
Employee benefits	42,207,549 ✓	41,617,167
Supplies	84,145,703 ✓	82,839,990
Contract services	35,662,277 ✓	29,564,442
Repairs and maintenance	13,267,197 ✓	10,183,072
Provision for bad debts	42,870,882 ✓	32,980,960
Depreciation and amortization	33,366,876 ✓	26,815,025
Interest	7,991,076 ✓	6,821,914
Utilities	9,299,035 ✓	8,785,201
Other	20,600,363 ✓	19,104,404
Total expenses	449,042,612	413,730,777
Income from operations	25,444,661	13,062,291
<b>Nonoperating gains</b>		
Investment income	7,011,572	7,154,075
Net income	32,456,233	20,216,366
<b>Other changes in unrestricted net assets</b>		
Net unrealized gain on investments	6,331,039	1,439,325
Change in minimum pension liability	-0-	9,843,527
Effect of adoption of recognition provisions of FAS 158	(18,597,458)	-0-
Other changes in unrestricted net assets	2,575,536	128,668
Change in unrestricted net assets	22,765,350	31,627,886
<b>Temporarily restricted net assets</b>		
Contributions, gifts and bequests	1,259,629	1,864,689
Net unrealized gain (loss) on investments	87,254	(144,157)
Investment income	1,370,943	707,062
Net assets released from restriction	(3,945,847)	(1,900,768)
Change in temporarily restricted net assets	(1,228,021)	526,826
Change in net assets	21,537,329	32,154,712
<b>Net assets</b>		
Beginning of year	345,501,924	313,347,212
End of year	\$ 367,039,253	\$ 345,501,924

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED SEPTEMBER 30, 2007 AND 2006

	2007	2006
<b>Operating activities</b>		
Change in net assets	\$ 21,537,329	\$ 32,154,712
Adjustments to reconcile change in net assets to net cash flows from operating activities		
Depreciation and amortization	33,366,876	26,815,025
Provision for bad debts	42,870,882	32,980,960
Net unrealized gain on investments	(6,418,293)	(1,295,168)
Amortization of deferred financing costs and original issue discount	174,798	178,845
Change in minimum pension liability and adoption of recognition provisions of FAS 158	18,597,458	(9,843,527)
Changes in operating assets and liabilities		
Patient accounts receivable	(51,345,889)	(48,845,028)
Other current assets	(331,326)	(1,670,572)
Accounts payable and other current liabilities	3,334,287	(6,232,615)
Salaries, wages and related liabilities	1,930,373	891,792
Estimated third-party payor settlements	(4,088,015)	954,298
Accrued interest	(30,462)	81,168
Pension liability and other	(7,588,437)	(2,910,887)
Net cash flows from operating activities	52,009,581	23,259,003
<b>Investing activities</b>		
Purchases of property and equipment	(10,789,698)	(56,785,062)
Transfers from trustee assets for principal, interest and construction draws	(50,108)	11,607,768
Withdrawals from funds held by trustee	-0-	10,666,338
Change in board designated funds	(40,929,022)	977,100
Change in other investments	1,315,275	(670,983)
Other	3,046,569	(2,647,568)
Net cash flows from investing activities	(47,406,984)	(36,852,407)
<b>Financing activities</b>		
Proceeds from notes payable	-0-	575,911
Repayments on long-term debt	(4,388,150)	(4,085,524)
Net cash flows from financing activities	(4,388,150)	(3,509,613)
Change in cash and cash equivalents	214,447	(17,103,017)
<b>Cash and cash equivalents</b>		
Beginning of year	19,917,854	37,020,871
End of year	\$ 20,132,301	\$ 19,917,854

See accompanying notes to consolidated financial statements.

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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### 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

#### Nature of Operations

Deaconess Health System, Inc. (System) is granted the authority to provide overall direction and control of its subsidiaries, the most significant of which is Deaconess Hospital, Inc. through the bylaws of the System and its subsidiaries.

Deaconess Hospital, Inc. (Hospital), located in Evansville, Indiana, is a general acute care facility with an operational capacity of 550 beds and associated ancillary service departments. The Hospital owned a psychiatric facility (Deaconess Cross Pointe Center, LLC). During 2007, Deaconess Cross Pointe Center, LLC became a department of the Hospital. The Hospital is a 50% owner in a joint venture (Deaconess Women's Hospital of Southern Indiana, LLC d/b/a The Women's Hospital) dedicated to providing healthcare services for women. The Hospital recorded an investment in The Women's Hospital of \$3,490,876 and \$2,584,503 as of September 30, 2007 and 2006, respectively. The Hospital holds a 50% ownership interest in an ambulatory surgery center (Evansville Surgery Associates, LLC). The Hospital recorded an investment in Evansville Surgery Associates, LLC of \$9,342,835 and \$8,559,684 as of September 30, 2007 and 2006, respectively.

In addition to holding ownership interests in Gateway Radiological Imaging, LLC – 80%, Deaconess Heart Center Cath Lab, LLC – 51%, Heartcare Health System, LLC – 70%, the Hospital, in 2007, acquired a 51% ownership interest in Progressive Health of Indiana, LLC.

The Hospital also holds a 22% ownership interest in an 80-bed rehabilitation facility (HealthSouth/Deaconess, LLC, d/b/a/ HealthSouth Deaconess Rehabilitation Hospital). The Hospital recorded an investment in the HealthSouth Deaconess Rehabilitation Hospital of \$3,885,488 and \$3,966,777 as of September 30, 2007 and 2006, respectively.

#### Principles of Consolidation

The consolidated financial statements include the accounts of Deaconess Health System, Inc. and its wholly owned and controlled subsidiaries. All material inter-company accounts and transactions have been eliminated in consolidation. Investments in organizations where the System's ownership percentage is equal to or less than 50% are included with other assets. The System's portion of income is reported with other revenue and was approximately \$9,839,450 and \$7,617,258 for the years ended September 30, 2007 and 2006, respectively.



# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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### Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, including the allowance for estimated uncollectible accounts and estimated third-party payor settlements, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period and could differ from actual results.

### Charity Care and Community Benefit

The System provides care to patients regardless of their ability to pay. A patient is classified as a charity patient by reference to certain established policies of the System. Essentially, these policies define charity services as those services for which no payment is anticipated based upon Federal Poverty Income Guidelines published by the Department of Health and Human Services and where incurred charges are considered significant when compared to the income of the patient. Because collection of amounts determined to qualify as charity care is not pursued, such amounts are not reported as revenue. Charity care provided during 2007 and 2006, measured at established rates, was \$24,891,820 and \$19,180,775, respectively. Uninsured self pay discounts provided to patients were \$2,491,244 and \$3,975,456 in 2007 and 2006, respectively. In addition, other programs and services for the benefit of the community are provided. The costs of these programs are included in operating expenses. The System receives reimbursements from certain governmental payors to assist in the funding of charity care.

### Statements of Cash Flows

Cash and cash equivalents are defined as investments in highly liquid debt instruments with a maturity of three months or less, excluding amounts whose use is limited by arrangements under trust agreements, board designation or by donors. The System maintains its cash in accounts, which at times may exceed federally insured limits. The System has not experienced any losses in such accounts and believes that it is not exposed to any significant credit risk on cash and cash equivalents.

Cash paid for interest, net of amount capitalized was \$8,021,538 and \$6,740,746 in 2007 and 2006, respectively. Interest expense capitalized was \$264,082 and \$1,062,235 in 2007 and 2006, respectively. Interest income capitalized was \$-0- and \$65,562 in 2007 and 2006, respectively. Noncash investing activities include property and equipment in liabilities of approximately \$549,000 and \$1,300,000 as of September 30, 2007 and 2006, respectively.

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## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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#### Patient Accounts Receivable, Estimated Third-Party Payor Settlements and Net Patient Service Revenue

Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others (principally insurers) for services rendered. Estimated retroactive adjustments under reimbursement agreements with certain third-party payors are included with estimated third-party payor settlements. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Components of net accounts receivable as of September 30, 2007 and 2006 are 21% and 26% Medicare, 4% and 4% Medicaid, 49% and 47% commercial insurers and managed care and 26% and 23% self pay and other, respectively.

Management estimates an allowance for uncollectible accounts receivable based on an evaluation of historical losses, current economic conditions, and other factors unique to the System's customer base.

#### Inventories

Inventories (principally pharmaceuticals and medical supplies) are stated at the lower of cost (first in, first out) or market.

#### Property and Equipment and Depreciation

Property and equipment are recorded at cost. Depreciation is provided over the estimated useful life of each class of depreciable asset using the straight-line method. Equipment under capital leases is amortized on the straight-line method over the lease term or the estimated useful life of the equipment, if shorter. Amortization is included with depreciation.

#### Investments Limited as to Use

Investments are stated at fair value. The fair values of investments are based on quoted market prices. Gains and losses on investments, including those sold, are based on the specific identification basis. Dividend and interest income and realized gains and losses on sales of investments are recorded as investment income. Unrealized appreciation (depreciation) in the fair value of investments is reported with other changes in net assets. The System does not engage in trading activities.

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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Investments limited as to use include assets held by trustees under indenture agreements and amounts set aside by the Board of Directors for future capital improvements and retirement of debt over which the Board retains control and may at its discretion subsequently designate for other purposes. Amounts required to meet current liabilities of the System have been classified as current assets.

#### Unamortized Debt Issuance Costs

Costs incurred in connection with the issuance of debt are amortized over the term of the related debt using the bonds outstanding method.

#### Financial Instruments

Financial instruments consist of cash and cash equivalents, investments, investments limited as to use, accounts receivable, current liabilities, and long-term debt obligations. The historical costs reported in the balance sheets for accounts receivable and current liabilities approximate their fair value. Management's estimate of the fair value of the other financial instruments is described above and in Notes 4 and 5 to the consolidated financial statements.

#### Medical Malpractice

Malpractice insurance coverage is provided under a claims-made policy. Should the claims-made policy be terminated, the Hospital has the option to purchase insurance for claims having occurred during its term but reported subsequently. Prior to July 1, 1999, the Indiana Medical Malpractice Act provided for a maximum recovery of \$750,000 per occurrence (\$3,000,000 annual aggregate) for professional liability, \$100,000 of which would be paid through the Hospital's malpractice insurance coverage and the balance would be paid by the State of Indiana Patient Compensation Fund. For claims on or after July 1, 1999, the Indiana Medical Malpractice Act provides for a maximum recovery of \$1,250,000 per occurrence (\$7,500,000 annual aggregate) with the first \$250,000 covered by the Hospital's insurance and the remainder by the Fund. Since October 1, 2003, the System has been a member in a Vermont captive insurance company, Indiana Healthcare Reciprocal RRG, LLC, to fund the Hospital's required portion of the professional, physician insurance coverage pursuant to the Act as well as its general liability insurance and excess coverage.

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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### Performance Indicator

"Net income" as reflected in the accompanying consolidated statements of operations and changes in net assets reflect the excess of revenues over expenses. Income from operations excludes investment income. Consistent with industry practice, unrealized gains and losses on investments, permanent transfers of assets and certain other items are excluded from net income.

### Pension Plan

The System's defined benefit pension plan covers substantially all employees. The benefits are based on years of service and each employee's compensation during the years of employment. Contributions to the plan include amortization of past service costs plus interest thereon over approximately ten years and are currently funded.

### Income Taxes

The System and Hospital are not-for-profit corporations as described in Section 501(c)(3) of the Internal Revenue Code (Code) and are exempt from federal and state income taxes on related income pursuant to Section 501(a) of the Code.

### Temporarily Restricted Net Assets

Temporarily restricted net assets include those assets whose use by the System has been temporarily limited primarily for capital projects or a specified time period or purpose. When a donor restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the consolidated statement of operations and changes in net assets as net assets released from restriction, which is included with other revenue.

### Advertising Costs

Advertising costs are expensed as incurred. Total expense for 2007 and 2006 was \$1,454,335 and \$1,966,381, respectively.

### Functional Expenses

The System provides health care services to patients in the community and the surrounding areas. Health care services and other certain related expenses were \$411,351,866 and \$379,003,958 for the years ended September 30, 2007 and 2006, respectively. General and administrative expenses were \$37,690,746 and \$34,726,819 for the years ended September 30, 2007 and 2006, respectively.

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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### Reclassification

Certain 2006 amounts in the consolidated financial statements have been reclassified to conform to the 2007 presentation. The effect of these reclassifications had no effect on previously-reported net income or net assets.

## 2. NET PATIENT SERVICE REVENUE

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

### Medicare

During the years ended September 30, 2007 and 2006, Medicare patient service revenue approximated 38% and 36%, respectively, of the System's net patient service revenue. Inpatient acute care services, outpatient services and physician services rendered to Medicare program beneficiaries are paid at prospectively determined rates. These rates vary according to patient classification systems that are based on clinical, diagnostic and other factors. Certain outpatient services and defined medical education costs related to Medicare beneficiaries are paid based on cost reimbursement methodologies. The Hospital's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. Inpatient non-acute care services are generally reimbursed based upon cost reimbursement methodologies.

### Medicaid

During the years ended September 30, 2007 and 2006, Medicaid patient service revenue approximated 5% and 4% in 2007 and 2006, respectively, of the System's net patient service revenue. Medicaid services are paid at prospectively determined rates per day or per discharge for inpatients or per occasion of service for outpatients.

To the extent that services to Medicare and Medicaid program beneficiaries are reimbursed based on cost reimbursement methodologies, final settlement is determined after submission of annual cost reports and audits thereof by the fiscal intermediary.

Estimates for final settlements of all unaudited Medicare and Medicaid cost reports through September 30, 2007 have been recorded. Cost reports through September 30, 2005 have been audited and settled as of September 30, 2007.

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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The Hospital has also entered into payment agreements with certain other commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges, and prospectively determined daily rates.

A reconciliation of the amount of services provided to patients at established rates to net patient service revenue as presented in the consolidated statements of operations and changes in net assets for 2007 and 2006 is as follows:

	<u>2007</u>	<u>2006</u>
Patient service revenue	\$ 1,048,878,964	\$ 928,805,206
Charity care revenue foregone	24,891,820	19,180,775
Uninsured self pay discounts	2,491,244	3,975,456
Contractual adjustments	568,678,693	497,012,775
Total adjustments	<u>596,061,757</u>	<u>520,169,006</u>
Net patient service revenue	<u>\$ 452,817,207</u>	<u>\$ 408,636,200</u>

Changes to any previous year's estimated settlement are reflected in the period the intermediary finalizes its audit of cost reports, or when additional information becomes available. Settlements related to prior year cost reports resulted in an increase to net patient service revenue of approximately \$3,119,000 and \$1,791,000 in 2007 and 2006, respectively.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Hospital believes that it is in compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

### 3. LONG-TERM DEBT

Long-term debt consists principally of tax-exempt revenue bonds as follows:

	2007	2006
Adjustable Convertible Extendible Securities		
Hospital Revenue Bonds, Series 1992		
Serial bonds, payable annually from January 2004 through January 2022 in amounts ranging from \$500,000 to \$1,700,000 plus interest at variable rates (3.88% and 3.75% as of September 30, 2007 and 2006, respectively)	\$ 16,800,000	\$ 17,400,000
Hospital Revenue Refunding Bonds, Series 1993		
Variable Rate Certificates with maturities beginning in 2004 and ending in 2024; interest rate at BMA plus 40 basis points (4.22% and 3.75% as of September 30, 2007 and 2006, respectively)	21,505,000	23,760,000
Hospital Revenue Refunding Bonds, Series 1999A		
Serial bonds, payable annually from March 2004 through March 2009 in amounts ranging from \$445,000 to \$580,000; interest rates ranging from 4.25% to 4.8%	1,130,000	1,660,000
Term bonds, payable from March 2010 through March 2029 in amounts ranging from \$605,000 to \$1,715,000 with interest; rates ranging from 5.50% to 5.75%	21,515,000	21,515,000
Hospital Revenue Bonds, Series 1999B		
Serial bonds, payable annually from January 2003 through January 2019 in amounts ranging from \$600,000 to \$1,600,000 plus interest at variable rates (5.18% and 5.37% as of September 30, 2007 and 2006, respectively)	13,700,000	14,400,000
Hospital Revenue Bonds, Series 2004A		
Term bonds, payable from March 2020 through March 2034 in amounts ranging from \$440,000 to \$8,065,000 with interest; rates ranging from 5.00% to 5.375%	54,765,000	54,765,000
Hospital Revenue Bonds, Series 2004B		
Serial bonds, payable annually from January 2010 through January 2029 in amounts ranging from \$870,000 to \$1,720,000 plus interest at variable rates (3.88% and 3.74% as of September 30, 2007 and 2006, respectively)	25,000,000	25,000,000
Original issue discounts and premiums, net	493,444	511,054
Notes payable, due in monthly installments through February 2011; interest ranging from 4.85% to 5.86%, secured by equipment	304,685	590,225
	155,213,129	159,601,279
Less current portion	4,580,528	4,253,495
Long-term debt, net of current portion	<u>\$ 150,632,601</u>	<u>\$ 155,347,784</u>

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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In 2004, Deaconess refinanced its existing Series 1993 Fixed Rate Bonds through the issuance of Variable Rate Certificates. The following is a brief summary of the refinancing:

- The Hospital obtained the appropriate approvals and documented amendments from the Trustee and called the Series 1993 Fixed Rate Bonds at the first optional call date in 2004 from the current bondholders, paying a call premium of 102.
- The Hospital sold the Series 1993 Fixed Rate Bonds to an unrelated third-party Financial Institution.
- The Financial Institution sold the Series 1993 Fixed Rate Bonds to a Trust (also a subsidiary of the Financial Institution).
- The Trust issued variable certificates, which will be remarketable and repriced weekly. Variable certificate holders will have the right to put their ownership interest in the Trust on a weekly basis at par.
- The Hospital entered into a Total Return Distribution Agreement with the Financial Institution under which the Hospital receives the fixed rate on the Series 1993 Fixed Rate Bonds and pays a variable rate equal to the BMA Index plus 40 basis points. This Agreement also includes a total return payment at termination equal to any gain (paid by the Financial Institution) or loss (paid by the Hospital) in the value of the Series 1993 Fixed Rate Bonds.

The Trust is considered a special-purpose entity. Deaconess still bears the risks and rewards of ownership due to the nature of the Total Return Distribution Agreement as discussed above. Based on the structure of this transaction, Deaconess has consolidated the activities of the Trust. In addition, both the Total Return Distribution Agreement between Deaconess and the Financial Institution and the Financial Institution's residual interest in the Trust are considered derivative instruments and marked to market in accordance with FASB Statement No. 133, 137, and 138 each period. The net result of this series of transactions is that Deaconess converted its old fixed rate debt to lower variable rate debt with substantial future savings.

The fair value of the fixed rate Hospital Revenue and Revenue Refunding Bonds (Series 1999A and 2004A approximated \$94,749,000 (carrying value of \$77,410,000) as of September 30, 2007. The fair value of the fixed rate obligations is estimated using discounted cash flow analyses, based on the Hospital's current incremental borrowing rates for similar types of borrowing arrangements. The fair value of variable rate debt (Series 1992, 1999B, 2004B and Variable Rate Certificates) approximates its carrying value.



## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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Interest rates for the variable rate Series 1992, 1999B and 2004B bonds and the Variable Rate Certificates are determined on a weekly basis. As provided in the bond agreements, the interest rate determination is subject to conversion, as elected by the Hospital, to other interest modes which determine the frequency, dates, and calculation of interest payments. In addition, bondholders have the option to present the Series 1992 or 1999B bonds for purchase at various times during the year. Commercial banks have agreed, pursuant to two separate Standby Purchase and Credit Agreements (Agreements), to provide liquidity support should any of the Series 1992 or 1999B bonds presented by bondholders for purchase not be remarketed. The Agreements are subject to renegotiations and renewals.

The Series 1992, 1999B and 2004B bonds are secured by letters of credit in amounts equal to the outstanding balances of these bonds as of September 30, 2007. The letters of credit expire at various times through April 2012. Additionally, the Series 1992, 1999A, 1999B, 2004A and 2004B bonds and the Variable Rate Certificates are secured by a security interest in the Hospital's revenue. The System covenants that it will not permit any lien or security interest on the Hospital facility other than certain permitted encumbrances. In addition, the various agreements require maintenance of certain debt service income ratios, limit additional borrowings, and require compliance with various other restrictive covenants.

Aggregate maturities of long-term debt are as follows:

<u>Year Ending September 30,</u>	
2008	\$ 4,580,528
2009	4,721,804
2010	5,052,353
2011	6,155,000
2012	6,490,000
Thereafter	<u>128,213,444</u>
	<u>\$ 155,213,129</u>

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

### 4. INVESTMENTS

A detail of investment income for 2007 and 2006 is as follows:

	2007	2006
Interest and dividends	\$ 5,723,048	\$ 3,939,641
Net realized gains	1,032,326	2,990,591
Other, net	256,198	223,843
Investment income, net	<u>\$ 7,011,572</u>	<u>\$ 7,154,075</u>

Investments reported as current assets are those that the System has made available for use in operations within the next twelve months. Investments limited as to use that are required for obligations classified as current liabilities are also reported in current assets. Investments at fair value, consisted of the following:

	2007	2006
Funds held by trustee		
Cash and short-term investments	\$ 1,216,664	\$ 1,166,556
Less current portion	<u>1,216,664</u>	<u>1,166,556</u>
	-0-	-0-
Board designated funds		
Cash and short-term investments	3,600,965	770,599
US Government and government agency obligations	25,991,190	19,092,782
Corporate obligations	36,993,571	27,366,496
Marketable equity securities	75,560,424	47,775,362
Accrued interest and other	<u>351,438</u>	<u>232,288</u>
	142,497,588	95,237,527
Temporarily restricted		
Cash and short-term investments	112,169	412,188
US Government and government agency obligations	3,523,092	3,997,320
Marketable equity securities	5,552,146	5,951,043
Accrued interest and other	<u>19,284</u>	<u>74,161</u>
	9,206,691	10,434,712
Investments limited as to use, net	<u>\$ 151,704,279</u>	<u>\$ 105,672,239</u>

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

### 5. PENSION PLANS

The System offers a noncontributory defined benefit pension plan covering all eligible employees. Benefits are based on each participant's years of service and compensation. Contributions to the plan are based on actuarially determined amounts sufficient to meet the benefits to be paid to plan participants.

On September 30, 2007, the System adopted the recognition provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (FAS 158), which required the System to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of the plan in its consolidated balance sheet.

The following table sets forth the funded status of the defined benefit plan and amounts recognized in the financial statements as of and for the years ended September 30, 2007 and 2006.

	2007	2006
Change in benefit obligation		
Benefit obligation, beginning of year	\$ 105,496,315	\$ 103,320,244
Service cost	4,555,028	4,243,424
Interest cost	7,059,897	6,121,044
Benefits paid	(2,620,586)	(2,448,100)
Actuarial (gain) loss	2,723,190	(5,740,297)
Benefit obligation, end of year	<u>\$ 117,213,844</u>	<u>\$ 105,496,315</u>
Changes in plan assets		
Fair value of plan assets, beginning of year	\$ 89,226,373	\$ 76,647,449
Actual return on plan assets	12,275,185	6,591,024
Employer contributions	8,076,000	8,436,000
Benefits paid	(2,620,586)	(2,448,100)
Fair value of plan assets, end of year	<u>\$ 106,956,972</u>	<u>\$ 89,226,373</u>
Funded status		
Funded status of the plan, end of year	<u>\$ (10,256,872)</u>	<u>\$ (16,269,942)</u>
Amounts recognized in the consolidated balance sheets consist of		
Other assets	\$ -0-	\$ 5,415,609
Other long-term liabilities	(10,256,872)	-0-
Total	<u>\$ (10,256,872)</u>	<u>\$ 5,415,609</u>

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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Pension disclosures related to the adoption of FAS 158 as of and for the year ended September 30, 2007 include:

Amounts not yet reflected in net periodic benefit cost and included in other changes in unrestricted net assets	
Transition obligation asset (obligation)	\$ -0-
Prior service cost	(322,506)
Accumulated loss	<u>(18,274,952)</u>
Other changes in unrestricted net assets	(18,597,458)
Cumulative employer contributions in excess of net periodic pension cost	<u>8,340,586</u>
Net amount recognized in the consolidated balance sheets (after FAS 158)	<u>\$ (10,256,872)</u>
Changes in unrestricted net assets due to application of FAS 158	
Additional minimum liability before FAS 158	\$ -0-
Intangible asset offset before FAS 158	<u>-0-</u>
Other changes in unrestricted net assets before FAS 158	\$ -0-
Change in unrestricted net assets due to application of FAS 158	\$ (18,597,458)
Estimated amounts that will be amortized from other changes in unrestricted net assets over the next fiscal year	
Amortization of transition (obligation) asset	\$ -0-
Amortization of prior service (cost) credit	\$ (186,450)
Amortization of loss	\$ (525,547)

# DEACONESS HEALTH SYSTEM, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

Other pension disclosures for 2007 and 2006 include:

	2007	2006
Components of net periodic benefit cost		
Service cost	\$ 4,555,028	\$ 4,243,424
Interest cost	7,059,897	6,121,044
Expected return on plan assets	(7,820,526)	(6,744,292)
Amortization of prior year service cost	186,450	186,450
Amortization of loss	1,170,174	1,400,818
Net periodic benefit cost	<u>\$ 5,151,023</u>	<u>\$ 5,207,444</u>
Other changes in unrestricted net assets attributable to change in additional minimum liability recognition	\$ -0-	\$ (9,843,527)
Additional year end information		
Projected benefit obligation	\$ 117,213,844	\$ 105,496,315
Accumulated benefit obligation	\$ 93,798,238	\$ 84,933,315
Fair value of plan assets	\$ 106,956,972	\$ 89,226,373
Weighted-average actuarial assumptions as of September 30 are		
Discount rate	6.50%	6.50%
Expected return on plan assets	8.50%	8.50%
Rate of compensation increase	4.50%	4.50%

The following is a schedule by year of expected benefit payments as of September 30, 2007

Year Ending September 30,	
2008	\$ 2,986,406
2009	3,197,214
2010	3,503,663
2011	3,919,503
2012	4,506,716
2013-2017	<u>32,942,117</u>
	<u>\$ 51,055,619</u>

Determination of net periodic pension cost for the years ended September 30, 2007 and 2006 is based on assumptions and census data as of January 1, 2007 and 2006, respectively.

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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The principal long-term determinant of a portfolio's investment return is its asset allocation. The plan allocation includes growth assets (60%) and fixed income (38%). In addition, active management strategies have added value relative to passive benchmark returns. The expected long-term rate of return assumption is based on the mix of assets in the plan, the long-term earnings expected to be associated with each asset class, and the additional return expected through active management. This assumption is periodically benchmarked against peer plans.

As permitted under Paragraph 26 of FAS 87, Employers' Accounting for Pensions, the amortization of any prior service cost is determined using a straight-line amortization of the cost over the average remaining service period of employees expected to receive benefits under the Plan.

The Plan's weighted-average, asset allocations as of September 30, 2007 and 2006, by asset category, are as follows:

	<u>2007</u>	<u>2006</u>
Mutual funds - equity funds	55%	54%
Mutual funds - bond funds	38%	38%
Marketable equity securities	5%	5%
Other	<u>2%</u>	<u>3%</u>
	<u>100%</u>	<u>100%</u>

The allocation strategy for the Plan currently comprises approximately 50% to 70% growth investments (target of 60%) and 30% to 50% fixed-income investments (target of 40%). Within the growth investment classification, the plan asset strategy encompasses equity and equity-like instruments that are expected to represent approximately 60% of the System's plan asset portfolio of both public and private market investments. The largest component of these equity and equity-like instruments is public equity securities that are well diversified and invested in U.S. and international companies.

The System expects to contribute in excess of the required funding amounts to its pension plan in 2008, currently approximating \$8,004,000.

The System also offers a 401k plan to eligible employees. Total expense for the System's matching contributions for eligible employees for 2007 and 2006 was \$1,659,259 and \$1,503,338, respectively.

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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#### 6. RELATED PARTY TRANSACTIONS

The System is a joint-owner of Deaconess Women's Hospital of Southern Indiana, LLC d/b/a The Women's Hospital, a 74 bed full-service women's health care facility located in Newburgh, Indiana. The System owns the building in which The Women's Hospital is located and leases the space to The Women's Hospital currently at \$230,000 per month with an option to increase that amount annually through June 2030. The System also carries a note receivable from the facility of \$673,930 and \$763,468 as of September 30, 2007 and 2006, respectively.

The System owned a minority interest in a local multi-specialty physician clinic. During 2006, the physician clinic also owned and operated a health maintenance organization. The System extended a \$6 million subordinated note to the physician clinic in order to meet statutory reserve requirements mandated for the health maintenance organization. As of September 30, 2006, the physician clinic liquidated its ownership in the health maintenance organization subsequently terminating the System's subordinated note.

During 2007, the System liquidated its minority interest in the local multi-specialty physician clinic.

#### 7. COMMITMENTS AND CONTINGENCIES

##### Operating leases

The System leases various equipment and facilities under operating leases expiring at various dates through 2011. Total lease expense for 2007 and 2006 was \$12,250,477 and \$11,921,234, respectively. The following is the minimum lease payments for the years after September 30, 2007:

<u>Year Ending September 30,</u>	
2008	\$ 9,110,750
2009	7,537,311
2010	6,056,125
2011	1,941,291
2012	978,524
Thereafter	3,700,897
	<u>\$ 29,324,898</u>

## DEACONESS HEALTH SYSTEM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2007 AND 2006

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#### Litigation

The System is involved in litigation and regulatory investigations arising in the course of business. After consultation with legal counsel, management estimates that these matters will be resolved without material adverse effect on the System's future financial position or results from operations.



SUPPLEMENTARY INFORMATION

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATING BALANCE SHEET SEPTEMBER 30, 2007

	Consolidated	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Assets</b>				
Current assets				
Cash and cash equivalents	\$ 20,132,301	\$ -0-	\$ 5,788,664	\$ 14,343,637
Funds held by trustee, current portion	1,216,664	-0-	-0-	1,216,664
Patient accounts receivable, net	82,737,622	-0-	171,588	82,566,034
Inventories	2,292,081	-0-	-0-	2,292,081
Prepaid expenses and other current assets	6,852,211	99,597	218,847	6,533,767
Total current assets	113,230,879	99,597	6,179,099	106,952,183
Investments limited as to use, less current portion				
Board designated funds	142,497,588	-0-	-0-	142,497,588
Temporarily restricted	9,206,691	-0-	-0-	9,206,691
Total investments limited as to use	151,704,279	-0-	-0-	151,704,279
Property and equipment				
Land and improvements	17,240,539	-0-	2,984,115	14,256,424
Buildings and fixed equipment	361,327,371	-0-	37,561,516	323,765,855
Movable equipment	160,251,835	-0-	774,789	159,477,046
	538,819,745	-0-	41,320,420	497,499,325
Less allowances for depreciation	270,646,009	-0-	23,429,697	247,216,312
	268,173,736	-0-	17,890,723	250,283,013
Construction in progress	6,691,971	-0-	-0-	6,691,971
Total property and equipment, net	274,865,707	-0-	17,890,723	256,974,984
Other assets				
Deferred financing costs	2,841,661	-0-	-0-	2,841,661
Investments in joint ventures and other	31,651,275	(73,229)	54,368	31,670,136
	34,492,936	(73,229)	54,368	34,511,797
Total assets	\$ 574,293,801	\$ 26,368	\$ 24,124,190	\$ 550,143,243

See report of independent auditors on page 1.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATING BALANCE SHEET SEPTEMBER 30, 2007

	Consolidated	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Liabilities and net assets</b>				
Current liabilities				
Accounts payable and other current liabilities	\$ 17,957,838	\$ 99,597	\$ 352,464	\$ 17,505,777
Salaries, wages and related liabilities	18,189,714	-0-	147,930	18,041,784
Estimated third-party payor settlements	909,265	-0-	13,692	895,573
Accrued interest	634,658	-0-	-0-	634,658
Current portion of long-term debt	4,580,528	-0-	-0-	4,580,528
Total current liabilities	42,272,003	99,597	514,086	41,658,320
Long-term liabilities				
Long-term debt, less current portion	150,632,601	-0-	-0-	150,632,601
Other long-term liabilities	14,349,944	-0-	-0-	14,349,944
Total long-term liabilities	164,982,545	-0-	-0-	164,982,545
Total liabilities	207,254,548	99,597	514,086	206,640,865
Net assets				
Unrestricted	357,832,562	(73,229)	23,610,104	334,295,687
Temporarily restricted	9,206,691	-0-	-0-	9,206,691
Total net assets	367,039,253	(73,229)	23,610,104	343,502,378
 Total liabilities and net assets	 \$ 574,293,801	 \$ 26,368	 \$ 24,124,190	 \$ 550,143,243

See report of independent auditors on page 1.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATING STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS YEAR ENDED SEPTEMBER 30, 2007

	Consolidated	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Unrestricted revenue and other support</b>				
Net patient service revenue	\$ 452,817,207	\$ -0-	\$ 3,147,121	\$ 449,670,086
Other revenue	21,670,066	(1,569,633)	3,901,801	19,337,898
Total unrestricted revenue and other support	474,487,273	(1,569,633)	7,048,922	469,007,984
<b>Expenses</b>				
Salaries and wages	159,631,654	-0-	1,797,861	157,833,793
Employee benefits	42,207,549	-0-	279,974	41,927,575
Supplies	84,145,703	-0-	266,628	83,879,075
Contract services	35,662,277	-0-	1,028,977	34,633,300
Repairs and maintenance	13,267,197	-0-	165,599	13,101,598
Provision for bad debts	42,870,882	-0-	218,068	42,652,814
Depreciation and amortization	33,366,876	-0-	1,261,387	32,105,489
Interest	7,991,076	-0-	-0-	7,991,076
Utilities	9,299,035	-0-	486,034	8,813,001
Other	20,600,363	(1,569,633)	1,177,027	20,992,969
Total expenses	449,042,612	(1,569,633)	6,681,555	443,930,690
Income from operations	25,444,661	-0-	367,367	25,077,294
<b>Nonoperating gains</b>				
Investment income	7,011,572	-0-	134,965	6,876,607
Net income	32,456,233	-0-	502,332	31,953,901
<b>Other changes in unrestricted net assets</b>				
Net unrealized gain on investments	6,331,039	-0-	-0-	6,331,039
Effect of adoption of recognition provisions of FAS 158	(18,597,458)	-0-	-0-	(18,597,458)
Other changes in unrestricted net assets	2,575,536	-0-	-0-	2,575,536
Change in unrestricted net assets	22,765,350	-0-	502,332	22,263,018
<b>Temporarily restricted net assets</b>				
Contributions, gifts, and bequests	1,259,629	-0-	-0-	1,259,629
Net unrealized loss on investments	87,254	-0-	-0-	87,254
Investment income	1,370,943	-0-	-0-	1,370,943
Net assets released from restriction	(3,945,847)	-0-	-0-	(3,945,847)
Change in temporarily restricted net assets	(1,228,021)	-0-	-0-	(1,228,021)
Change in net assets	21,537,329	-0-	502,332	21,034,997
<b>Net assets</b>				
Beginning of year	345,501,924	(73,229)	23,107,772	322,467,381
End of year	\$ 367,039,253	\$ (73,229)	\$ 23,610,104	\$ 343,502,378

See report of independent auditors on page 1.

# DEACONESS HEALTH SYSTEM, INC.

## CONSOLIDATING STATEMENT OF CASH FLOWS YEAR ENDED SEPTEMBER 30, 2007

	Consolidated	Eliminations	Deaconess Health System, Inc.	Deaconess Hospital, Inc.
<b>Operating activities</b>				
Change in net assets	\$ 21,537,329	\$ -0-	\$ 502,332	\$ 21,034,997
Adjustments to reconcile changes in net assets to net cash flows from operating activities				
Depreciation and amortization	33,366,876	-0-	1,261,387	32,105,489
Provision for bad debts	42,870,882		218,068	42,652,814
Net unrealized gain on investments	(6,418,293)	-0-	-0-	(6,418,293)
Amortization of deferred financing costs and original issue discount	174,798	-0-	-0-	174,798
Change in minimum pension liability and adoption of recognition provisions of FAS 158	18,597,458	-0-	-0-	18,597,458
Changes in operating assets and liabilities				
Patient accounts receivable	(51,345,889)	-0-	(127,621)	(51,218,268)
Other current assets	(331,326)	(146,060)	73,039	(258,305)
Accounts payable and other current liabilities	3,334,287	146,060	(104,877)	3,293,104
Salaries, wages and related liabilities	1,930,373	-0-	15,905	1,914,468
Estimated third-party payor settlements	(4,088,015)	-0-	13,692	(4,101,707)
Accrued interest	(30,462)	-0-	-0-	(30,462)
Pension liability and other	(7,588,437)	-0-	-0-	(7,588,437)
Net cash flows from operating activities	52,009,581	-0-	1,851,925	50,157,656
<b>Investing activities</b>				
Purchases of property and equipment	(10,789,698)	-0-	(350,157)	(10,439,541)
Transfers from trustee assets for principal, interest and construction draws	(50,108)	-0-	-0-	(50,108)
Change in board designated funds	(40,929,022)	-0-	-0-	(40,929,022)
Change in other investments	1,315,275	-0-	-0-	1,315,275
Other	3,046,569	-0-	(207)	3,046,776
Net cash flows from investing activities	(47,406,984)	-0-	(350,364)	(47,056,620)
<b>Financing activities</b>				
Repayments on long-term debt	(4,388,150)	-0-	-0-	(4,388,150)
Change in cash and cash equivalents	214,447	-0-	1,501,561	(1,287,114)
<b>Cash and cash equivalents</b>				
Beginning of year	19,917,854	-0-	4,287,103	15,630,751
End of year	<u>\$ 20,132,301</u>	<u>\$ -0-</u>	<u>\$ 5,788,664</u>	<u>\$ 14,343,637</u>

See report of independent auditors on page 1.

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